April 12, 2013

The Honorable Vern Buchanan
Chair, Small Business/Pass Throughs
Working Group
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

The Honorable Allyson Schwartz
Vice Chair, Small Business/Pass Throughs
Working Group
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Re: Comments: Small Business/Pass Throughs Tax Reform Working Group

Dear Congressman Buchanan and Congresswoman Schwartz:

On March 12, 2013, the Chairman of the House Ways and Means Committee released a discussion draft aimed at creating a simpler and fairer tax code for small businesses. This discussion draft includes two separate options designed to modernize the taxation of S corporations and partnerships. The Committee has requested comments from stakeholders on both options – one that revises current rules ("Option 1") and a second that replaces current tax rules with a new unified pass-through regime ("Option 2").

We note that each of us joining in these comments is either a current or former Chair of the S Corporations Committee of the Tax Section of the American Bar Association or a current Vice Chair of that Committee. However, we are submitting these comments in our individual capacities, and ***not*** on behalf of the American Bar Association, its Tax Section, or the S Corporations Committee or on behalf of our firms or employers. We also note that, while those of us joining in these comments have clients who would be affected by the federal tax law principles addressed herein and have advised clients on the application of such principles, we have not been engaged by a client to make this submission or otherwise to influence the development or outcome of, the subject matter of these comments.

Before touching on substantive thoughts, we want to first applaud the efforts of the Ways and Means Committee and its members toward improving the tax and business climates for closely-held businesses. While not all closely-held businesses are small, almost all smaller businesses are closely-held. These businesses are primary engines of economic growth for our country. The costs of complexity in tax and other statutes and regulations on smaller businesses are disproportionately higher than on larger businesses with larger asset bases and more employees over which to absorb and spread those costs. We believe that any reduction in these burdens on closely-held businesses will produce long-term benefits.

Option 1 and Option 2

We believe that Option 1 in the discussion draft includes useful changes that would improve the current subchapter S rules. However, we have concerns that Option 2 in the discussion draft would be burdensome and would raise compliance costs for many small businesses. We believe that there is good reason for, and a clear need for, a separate set of rules that operates on a simple basis for simple structures. Subchapter S was enacted in 1958 to reduce the impact of tax consequences on the choice of business form and to avoid the burden of double tax on small businesses. Subsequent revisions to subchapter S have resulted in a pass-through approach that is simpler than subchapter K, especially considering the increasing complexity of subchapter K as it has developed over the last several decades. The attractiveness of subchapter S is reflected by the fact that S corporations have been the most popular entity choice in recent years.[1] Subchapter S is more easily managed by many small business owners,[2] and we believe such a simplified approach should remain available to them. The proposal presented under Option 1 represents an approach that we believe to be beneficial, essentially making incremental changes to make S corporation status an even more workable and accessible business form for operating a closely-held business.

We further are concerned that pursuing Option 2, which would consolidate all pass-through entities under a new subchapter K and convert all S corporation into new creatures, i.e., "passthrough corporations," would continue to require distinctions between corporations and noncorporate pass-through entities, as is evidenced by the discussion draft. Moreover the need for a simplified structure for certain pass-through entities would remain. These distinctions are already present, and this need is met, in the present law with separate subchapters S and K. We believe that combining the two in the approach taken by Option 2 likely would create a more confusing and complicated environment for many taxpayers, would not simplify things, and, in fact, likely would create many traps for the unwary, especially for those taxpayers who are presently willing to exchange the greater flexibility and complexity of subchapter K for the greater simplicity of subchapter S.

Finally, we do not believe that forcing existing S corporations, many of which have been functioning as such for twenty or thirty years, into this new subchapter K status would help foster economic growth or provide any economic benefit to these entities, but instead likely would have a disruptive effect to many of them, with the transition issues alone being likely to add considerable unneeded complexity to their tax situations.

Option 1 Enhancements to Subchapter S.

We welcome the proposals to enhance subchapter S listed under Option 1. For example, we support permanently reducing to five years (from ten years) the built-in gains recognition period – the period following a C corporation's conversion to S corporation status during which it must pay a corporate-level tax on certain net realized built-in gains. "Built-in gain" generally refers to unrealized income or appreciation inherent in assets at the time of the conversion (or in property received by an S corporation from a C corporation in a carryover basis transaction). The built-in gains tax was originally enacted to prevent a corporation from circumventing the repeal of the

[1] The Internal Revenue Service statistics for the most recent years for which information is available show that S corporation returns (4,094,562 for tax year 2009) outnumbered partnership returns (3,248,481 for tax year 2010). IRS Publication 4198, *2012 Tax Statistics*.
[2] *See* S. Rep. No. 640, 97th Cong., 2d Sess. 1 (1982) ("In general, the subchapter S Revision Act of 1982 is intended to simplify and modify the tax rules ... that tend to create traps for the unwary.")

so-called *General Utilities* doctrine by converting to pass-through status and then liquidating. The tax generally is triggered if the S corporation disposes of built-in gain assets during the recognition period in a transaction in which gain or loss is recognized.

The impact of the built-in gains tax may be quite significant when coupled with the individual-level tax imposed on the built-in gain passed through to the shareholders. As a consequence, S corporations may avoid or delay restructurings or dispositions of assets no longer required or needed in the operation of the business, which can have an adverse effect on the business, and, in turn, can adversely affect the economy at large. We believe that, once a reasonable period has passed to accomplish the purposes behind the built-in gains tax, the tax laws should no longer discourage sales of assets that no longer serve a productive purpose in the operation of a closely held business. We further believe that a five-year period is sufficient to accomplish the purposes of the built-in gains tax, and that a longer period might well be counterproductive.

Moreover, if the recognition period were to revert to a period longer than five years, that change itself could create complications that would be avoided by making the five-year period permanent. Indeed, the temporary nature of the current rules governing the period during which the built-in gains tax applies creates uncertainty and can distort business decisions by encouraging taxpayers to accelerate sales rather than risk that a tax that does not apply currently may apply in a subsequent year.

We note finally that the built-in gains tax is a parallel tax system with its own set of complex rules. We believe that limiting the application of this tax to five years instead of ten would help reduce both the complexity of the tax laws and the record-keeping burdens of those to whom the built-in gains tax might otherwise continue to apply.

We also support the proposals with respect to charitable contributions, specifically modifying the shareholder basis adjustment rules for S corporations making charitable contributions and allowing a U.S. electing small business trust (an "ESBT") to deduct charitable contributions made by the S corporation subject to the contribution limits and carryover rules applicable to individual donors. We also support the proposal permitting non-resident aliens to be S corporation shareholders through an ESBT. Because an ESBT is separately taxed on income earned from the S corporation, non-resident aliens will be subject to U.S. tax on their interests in S corporation income.

We note that many of the proposals included in Option 1 of the Ways and Means Committee discussion draft are consistent with the objectives of the "Options for Tax Reform in Subchapter S of the Internal Revenue Code" submitted on April 10, 2013, by the American Bar Association Section of Taxation to the Chairman and Ranking Members of the House Committee on Ways & Means and the Senate Finance Committee ("ABA Comments"), which are to improve tax laws and to make them simpler to understand and to administer. With these objectives in mind, we applaud the fact that Option 1 would repeal excess passive investment income as a termination event. We also believe that increasing the threshold for excess passive investment income is a step in the right direction. Nonetheless, we respectfully request that you consider repealing the tax on excess net passive investment income entirely. As noted in the ABA Comments, taxpayers who are aware of the tax on excess passive investment income plan their business operations accordingly to minimize or avoid this tax. For less sophisticated S corporations, this tax is a trap for the unwary, and may result in costly corrective action. Repealing the tax would eliminate such traps, reduce administrative and recordkeeping requirements for S corporations, and promote a simpler and fairer tax code for small businesses – benefits that we believe outweigh any policy arguments in support of retaining the tax.

Thank you for your consideration of these comments. Please let us know if we could provide any additional clarification or assistance.

Respectfully submitted,

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